

Statement on behalf of the National Association of Home Builders

Committee on Ways and Means

Hearing on

The Treatment of Closely-Held Businesses in the Context of Tax Reform

March 7, 2012

The National Association of Home Builders (NAHB) appreciates the opportunity to submit this statement on the "Treatment of Closely-Held Businesses in the Context of Tax Reform."

Founded in 1942, NAHB is a federation of more than 800 affiliated state and local building industry associations. It is the voice of the housing industry in the United States. NAHB represents more than 140,000 builder and associate members throughout the country, including individuals and firms that construct and supply single-family homes, as well as apartment, condominium, multifamily, commercial and industrial builders, land developers and remodelers.

Residential Construction is Small Business Dominated

The residential construction sector, which includes single-family and multifamily home builders, remodelers and other businesses connected to the housing sector, is dominated by small businesses. The median NAHB home builder member has 4 employees, constructs 3 homes per year, and reports less than \$1 million in gross receipts. Approximately 80% of NAHB's membership consists of businesses organized as non C-Corporation entities (sole proprietorships, partnerships, LLCs and S Corporations). Of the 20% of members organized as C Corporations, very few are publicly-traded corporations.

Because housing plays such a central role in the economy, tax changes that impact pass-thru entities could have a broad impact—both positive and negative—on the economy as a whole. Housing contributes to gross domestic product (GDP) in two basic ways: through private residential investment and consumption spending on housing services. Historically, residential investment has averaged roughly 5 percent of GDP while housing services have averaged between 12 and 13 percent, for a combined 17 to 18 percent of GDP. These shares tend to vary over the business cycle. Residential investment includes construction of new single family and multifamily structures, residential remodeling, production of manufactured homes, and brokers' fees. Consumption spending on housing services includes gross rents (which include utilities) paid by renters, and owners' imputed rent (an estimate of how much it would cost to rent owner-occupied units), and utility payments.

Currently, because of the impacts of the Great Recession, housing's total contribution to GDP stands at 14.9 percent. Housing starts are down by more than 75% since their peak at the beginning of 2006, with more than 1.45 million jobs lost in the residential construction sector. Home prices are down approximately one-third from 2006 levels, wiping out trillions of dollars of wealth of the nation's 75 million homeowners.

The ongoing depression in the residential construction industry also translates into lower federal tax revenue as builders and the housing service sector struggle. Residential construction provides a sizeable revenue source for local, state and federal governments. NAHB strongly believes there is great potential for increased revenue if tax reforms are implemented that both promote economic growth and recognize the importance of housing to the economy.

NAHB estimates the following economic impacts from home building and remodeling.¹ Construction of an average single-family home creates 3.05 jobs and generates \$89,216 in federal, state, and local tax revenue. Construction of an average multifamily unit creates 1.16 jobs and generates \$33,494 in federal, state and local tax revenue. Expenditures of \$100,000 of remodeling improvements create 1.11 jobs and generates \$30,217 in federal, state and local tax revenue.

Until the nation's housing markets recover, there can be no robust economic recovery for the economy at large. Housing is linked to household wealth, consumer confidence, a healthy labor market (by enabling people to locate from city to city), and the direct jobs impact connected to the housing industry.

Business Tax Policy and Home Building

Given that most home builders and remodelers are organized as pass-thru entities for tax purposes, the individual income tax rate system functions as the de facto business tax rate. For this reason, the nation's home builders support extending the 2001/2003 individual income tax rate reductions.

Furthermore, as small firms, there are certain tax rules that help reduce the administrative burden that complicated tax rules can impose on businesses that do not have in-house tax expertise. Good examples of the simplifying rules include the section 179 small business expensing provisions and the cash tax accounting rules. Both of these provisions significantly reduce the compliance costs of the existing tax code. Moreover, cash accounting is critical for small firms because it helps prevent a timing mismatch between taxes paid and actual revenue received. Under an accrual basis, it is possible for small firms to owe taxes before revenue is in hand, thereby creating cash flow challenges. Such taxation would constitute tax of "phantom income," as it requires paying taxes on money not yet received by the business.

¹ The Direct Impact of Home Building and Remodeling on the U.S. Economy. NAHB Economics Group. (<http://www.nahb.org/generic.aspx?sectionID=734&genericContentID=103543&channelID=311>)

Another important rule for home builders that helps prevent taxation on phantom income is the section 460(e) home construction contract exception to the long-term tax accounting rules. In general, the tax code requires businesses operating under contracts that require more than one tax year to complete (long-term contracts) to pay taxes on the expected revenue (a form of phantom income) proportionally for each year of the contract. This is in contrast to the completed contract method.

These rules were established by the Tax Reform Act of 1986 to ensure large businesses operating under contracts lasting many years did not defer tax liability for long periods of time. This would occur in absence of the long-term contract rules because such taxpayers could defer income tax payment until the contract was completed.

Section 460(e) provides an important exception to these long-term contracts for certain home building contracts. This change was made after the 1986 reform effort because it was recognized that home building was an example of a small business under which construction could take slightly more than a year (or span two tax years). The home construction contract exception allows home builders to use the completed contract method of tax accounting, thereby preventing home builders from having to finance half of the expected income tax payment associated with the construction and sale of a home, as would be required under the long-term tax accounting rules. Under the tax code, a qualified home construction contract is a construction contract for which at least 80 percent of the estimated total costs are reasonably expected to be attributable to construction or development of the dwelling units contained in buildings with 4 or fewer units and improvements to real property located on the site of such units.

Finally, due to the Great Recession and its economic impacts, another form of phantom income taxes is taking a toll on many home builders across the nation. Section 108 of the tax code requires cancelled debt to be treated as taxable income. As part of the consequences of the housing market crisis, many builders own land that was purchased with acquisition, development and construction (AD&C) loans from both national and community banks. As land prices fell, some of these loans became distressed. Efforts were and continue to be made to mitigate troubled loans. Some of these market-based efforts involve limited principal reduction, interest rate decreases, term extensions, or other actions that would constitute cancellation of debt.

Unfortunately, such actions also give rise to income tax liability for small firms already facing the worst market environment since the Great Depression. As a result, the only option for many of these firms is declare bankruptcy or become insolvent. Unlike large firms, bankruptcy for many, small family-owned firms can mean the end of generations-old family enterprises.

As part of the American Recovery and Reinvestment Act of 2009, Congress provided an up to 10-year tax deferral for such income tax liability for debt forgiven in 2009 and 2010. However, for builders operating in states where debt issues became a factor in 2011, this deferral offered no benefit. And the deferral itself was of limited benefit for small businesses without the access

to lending and capital that large businesses possess and without which it is difficult to maintain operations.

For this reason, NAHB supports providing a tax exclusion for business debt forgiveness for debt mitigation efforts in 2011 and for a number of years thereafter, until the business economic environment substantially improves. Such a tax policy change would enable small, family owned firms to avoid bankruptcy and contribute to the economy recovery as individual local markets improve.

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